

# The Making of the Institutional Theory of Social Costs: Discovering the K. W. Kapp and J. M. Clark Correspondence\*

By SEBASTIAN BERGER†

**ABSTRACT.** This article reconstructs the making of the often “overlooked” institutional theory of social costs based on the unexploited correspondence between John Maurice Clark and Karl William Kapp. The reconstruction demonstrates that the institutional argument on social costs was developed as a critique of neoclassical economics and of post-WWII neoliberalism.

## Introduction

While most economists feel at ease to identify the boundaries of the discourse on social costs with the views of Pigou and Coase (see, for example, Aslanbeigui and Medema 1998), the distinct institutional argument developed by John Maurice Clark and Karl William Kapp has been largely eclipsed from the discourse (for efforts to revitalize this argument, see Berger 2012; Elsner, Frigato, and Ramazzotti 2012; Berger and Steppacher 2011; Gerber and Steppacher 2011). Therefore, this article has two main aims. Firstly, it reconstructs the making of the institutional argument based on unexplored archival materials, that is, the unpublished correspondence on social costs between Clark and Kapp. The aim is to analyze for the first time their important collaboration, and the development and relation of their arguments. This reveals and corrects imprecisions in the existing literature concerning their use of the term “social costs,” sheds new light on how Clark influenced Kapp, and highlights the uniqueness of their institutional argument as a full-fledged theory of social costs. Secondly, this article

\*I wish to thank two anonymous reviewers, Rolf Steppacher, and Andrew Farrant for detailed comments. I am grateful to Laurence Shute and Steve Medema for their interesting remarks. All remaining mistakes are my own.

†Currently, Visiting Scholar at the Department of Economics, Harvard University; beginning January 2014, Senior Lecturer in Economics, University of West England.

American Journal of Economics and Sociology, Vol. 72, No. 5 (November, 2013).

DOI: 10.1111/ajes.12040

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provides important evidence that the discourse on social costs can only be fully understood as an interaction between neoclassical, neoliberal, and institutional arguments.<sup>1</sup> That is, the institutional argument on social costs was developed not only as a critique of neoclassical economics, but also as a reply to the rise of post-WWII “neo”-liberalism, exemplified in the works of F. A. Hayek and L. Mises. The analysis illustrates how the reaction of leading members of the “neoliberal thought-collective” (see Mirowski and Plehwe 2009 for a sociology of this movement) contributed to the eclipse of the institutional argument on social costs. Thus, the article contributes an important detail to the account of the gradual demise of institutional economics in the period of the great neoliberal transformation of economics (Lee 2009; Rutherford 2011; Mirowski and Plehwe 2009). By reconstructing (Rorty 1984) the making of the institutional argument of social costs in the context of the social costs discourse with members of the “neoliberal thought-collective,” this article contributes to the recent sociology of economic knowledge.

### **The Kapp-Clark Correspondence in Context**

The Kapp-Clark correspondence on social costs is situated within the larger context of the demise of institutional economics as the dominant economic theory. Institutional economics is both a critique of neoclassical economics and a full-fledged and influential movement within economics (see Rutherford 2011; Kapp 2011; Dugger 2012). According to Rutherford, between 1926 and 1957 Clark was the leading institutional economist at Columbia, which was the center of institutional economics until the latter’s eventual demise. The institutionalist complement that emerged there during the 1920s was given a major boost by the hiring of Clark as Research Professor in Economics. Clark described his work as “social-institutional-dynamic theory,” developing a “realist economics” and an approach to social-liberal planning. Before coming to Columbia, he had already critiqued neoclassical theory and called for a more properly scientific economics that was relevant to the issues of its time. The year he arrived at Columbia, he published “Social Control of Business” (1926), which further developed ideas first expressed in “Overhead Costs”

([1923] 1931). His book discussed a large number of market failures that called for additional social controls. Market failure and regulation were key areas of institutional economics at Columbia. Clark agreed with legal realists in viewing law as a key instrument of social control to improve economic outcomes. Clark even co-taught a seminar on law and economics in the 1924 and 1925 terms. Until the late 1930s the institutional program at Columbia was well established. According to Kenneth Arrow, the Veblenian influence was still present at Columbia in the early 1940s; however, things had begun to change and the research program fissured into such a variety of approaches that by the late 1930s, even the leading institutionalists W. Mitchell and Clark would no longer acknowledge a distinct and coherent institutionalism. As elsewhere, the significance of mathematical economics grew and was symbolized by the hiring of George Stigler in 1947. By the early 1950s the department was divided between the prewar institutionalists, such as Clark, and the postwar neoclassical economists, such as Stigler. Clark retired in 1953 (for more details of this account of the situation at Columbia, see Rutherford 2011; for details concerning the development of Clark's economics, see Shute 1997).

Kapp had been a research assistant at the Institute for Social Research at Columbia and an instructor of economics at Columbia between 1937 and 1945 (for a brief biography, see Berger and Steppacher 2011), when institutional economics was still dominant but had entered into its declining stage. When Columbia's postwar hiring strategy favored neoclassical economists, Kapp left for Wesleyan University (CT) (see the accounts of Lee 2003 and Rutherford 2011 on the suppression and demise of institutional economics). The tremendous influence of Clark's work on overhead costs and social economics is acknowledged in Kapp's preface to "Social Costs of Private Enterprise" (1950). Its second—revised and enlarged—edition was entitled "Social Costs of Business Enterprise" (1963), signaling that the core of the institutional argument on social costs had already been stated by Veblen's "Theory of Business Enterprise" (1904). Kapp's work was widely reviewed and translated into many languages worldwide and made a significant impact on such events in the environmental movement in the 1970s as the 1972 UN Conference on Environment and Development, the formation of Ignacy Sachs' Center for Environment

and Development, and the Socialist Environment and Resource Association (SERA). Friedrich Pollock—a leading member of the Frankfurt School and close friend of Kapp—invited Kapp to participate in the newly constituted Institut für Sozialforschung in Frankfurt. Kapp's major project, however, to initiate an international association of institutional economists in collaboration with Gunnar Myrdal, eventually failed in the late 1960s due to a lack of funding.<sup>2</sup> After reaching its pinnacle of influence on the social costs discourse in the early 1970s, Kapp's institutional argument on social costs (see below) has gradually been eclipsed from the discourse.

### **J. M. Clark's Theory of Overhead Costs and Cost Shifting**

The following section shows how Clark derived the concept of cost shifting from his argument on overhead costs. This provides the intellectual context for the correspondence on Kapp's institutional theory of the social costs of private enterprise, as it is based on Clark's notion of cost shifting.<sup>3</sup> Clark's earliest letter in the Kapp Archives is dated Feb. 6, 1941 and is a reply to Kapp:

Dear Dr. Kapp, Your outline and sample chapters are very interesting; and I am naturally interested in your project of developing and applying some of my ideas. . . . Needless to say, I shall be interested in how your study develops.

What was the nature of these "ideas"? Clark developed his ideas mainly in "Overhead Costs" (1931), arguing that "overhead costs" refer to an

entire family of ideas, but they have one essential thing in common . . . they refer to costs that cannot be traced home and attributed to particular units of business . . . most of the real problems involve one other fact; namely that an increase or decrease in output does not involve a proportionate increase or decrease in cost. . . . the causes are real world complexities . . . unused productive capacity . . . "idle overhead" . . . unused powers of production. (Clark 1931: 1)

We have a considerable body of economic generalizations, bearing on the facts of that overhead costs are decidedly at variance with the assumptions and conclusions of that type of economics which searches for the conditions of a perfect equilibrium of supply and demand. (Clark 1931 in Gruchy 1967: 364)

Clark argued that the development of the forces of production in the 20<sup>th</sup> century, characterized by large amounts of fixed capital

equipment, a specialized workforce, and disequilibrium, required a corresponding theory of costs (Gruchy 1967: 365–366). Reviewing the conceptual history of costs, Clark concluded that “[t]he entire idea of expenses of production is . . . a rather recent one” (Clark 1931: 1) and that the neoclassical theory of costs was modeled on a long bygone economic reality where “virtually every element which economists now think of as an expense of production was paid for in such a fashion that each item could be directly charged to an item of product” (Clark 1931: 2). Neoclassical cost theory only held true under unique circumstances in which “expenses were virtually all traceable directly to units of product, and overhead costs were virtually non-existent” (Clark 1931: 2). Clark concluded that the “prevalent ideas on expenses of production date back to the domestic system and are not really appropriate to any later stage of industrial development” (Clark 1931: 2). Yet Clark argued that a proper theory of costs was crucial because “the backbone of the science of economics is the balancing of value against cost” (Clark 1931: 17). Clark asked the crucial question how the costs of producing an additional unit of output are determined:

Is the carload of lumber worth carrying if it covers all the costs that can be attributed to that single carload? . . . Shall we count the costs that would keep on even if the railroad shut down entirely? (Clark 1931: 19)

Clark concluded

Evidently, “cost” is an ambiguous term and . . . requires a thorough re-examination. (Clark 1931: 19)

There is no natural system of prices in the old sense. Cost prices do not mean anything definite anymore. (Clark 1931: 32)

What is counted as “costs” is thus a “convention” with “latitude” (Shute 1997: 60). This definition is fully in the tradition of institutional economics that focuses on the effects of habits of thought and institutions in the cumulative causation of the economic process. Clark used the concept of “shifting and conversion of overhead costs” of human labor in the business cycle<sup>4</sup> to elaborate this aspect of institutional theory of costs (Clark 1931: 25–27):

The cost to society of supporting a group of laborers does not vary with their output, for this cost goes on even though the laborers produce nothing, as is the case in periods of enforced idleness, which comes in the depression phase of the business cycle. (Gruchy 1967: 360)

Clark also extended the concept of overhead costs to mining and farming and called it “an ultimate fact” of human cost that must be maintained in depressions (Gruchy: 361–362). He determined the problem to be that business enterprises did not treat their costs as overhead but as variable costs. The converting of constant overhead costs into variable costs determined the process by which producers judged the profitability of production. Clark observed this, for example, in the business cycle when slowing sales trigger quantity adjustments by the laying off of workers (Clark 1931: 27–30). Clark introduced the terms “shifting and conversion of overhead costs” to describe how businesses make the workers responsible for their own maintenance, or throw the burden on society. These business measures create what Clark called the “accelerator effect” of laying off workers and further reducing purchasing power, leading to a deterioration of productive facilities, i.e., a kind of social damage accelerator. Clark described this in a metaphor: “All of which irresistibly suggests a man on a rock, jumping into the water for fear the tide will rise and wet him” (Clark 1931: 29). According to Clark, this reflected the conflict between social and private interests, since the former required capacity output while the latter sought to maximize revenue over variable costs (Clark 1931: 28–29).

This idea of cost shifting in the conflicting relationship between individual and social interests was a restatement of Veblen’s source theme that portrayed social waste as a consequence of the fact that business enterprise did not channel economic activity in ways consistent with public interests (Rutherford 2011: 36). Veblen’s pioneering analysis of institutions (including property rights, business-like and finance-like control of industry; see Gerber and Steppacher 2011) focused on social waste and damages. Veblen argued that capital resides in the continuity of ownership and that in a system of business enterprise and absentee ownership the “strong arm intervenes” to shuffle property rights so as to control and increase private pecuniary returns, which includes a subreptitious and predatory shifting of costs and thereby an avoidance of responsibility. Moreover, Veblen argued that this process of realignment of property rights via subreption and predation not only failed to guarantee, but systematically disregarded, the maintenance and efficient use of the material funds of production.

Veblen's examples included natural resource depletion—timberlands, fur-bearing animals, oil fields—next to sabotage of industrial and workers' efficiency, causing unnecessary social waste (Krall and Gowdy 2011).

The rethinking of the notion of costs led Clark to reformulate the notions of efficiency and accounting (Gruchy 1967: 365–367). Clark argued that estimating the efficiency of the total economy could not be undertaken by using data from private accounting because it did not account for all the costs of production. Clark proposed a new form of accounting that would indicate the discrepancies between commercial and community measures of efficiency. He supported a social cost keeping as a “form of economic reckoning which cuts through the sophisms of private financial accountancy and calls social waste by its true name”<sup>5</sup> (Gruchy 1967: 369). This new social accounting would be an effective device for judging the efficiency of the modern economy as a creator of “human values.” According to Clark, it was the duty of economists to reveal the shifted and neglected costs of operating our industrial system that were left unpaid by businesses, such as idle men and machinery, destruction of utilities through fashion, waste resulting from competitive advertisement, and private business secrecy. Clark viewed this as a problem of bringing this information to the public's attention and of putting an end to unpaid costs (Gruchy 1967: 369–370). Clark hoped that once it was understood how the legal and institutional matrix produced market values, the discrepancies between market and social valuation could be reduced (Gruchy 1967: 368).

A knowledge of the laws of overhead costs . . . opens many doors and is one of the indispensable avenues . . . overhead costs are not exceptions to a general economic law: they are the general law. (Clark 1931: 479)

In conclusion, Clark's argument on overhead costs and cost shifting constitute a further development of Veblen's ideas on social waste with a view to justify increasing social controls. In this institutional economics theory, the legal and institutional structure determines the extent to which firms have to pay the costs of production, so that prices based on costs including “mark-up” (Lee 1999) are a function of the institutional framework of society. Without proper legal restrictions and social controls, the latter remains a system of cost shifting,

a vicious circle of accelerating social damages. This theory of the institutional causes of cost shifting and social damages was developed by Kapp into the institutional theory of social costs, which is the subject matter of the following correspondence with Clark.

### **The Kapp-Clark Correspondence on Social Costs<sup>6</sup>**

How far did Clark influence Kapp in developing the institutional theory of social costs as a critique of the system of business enterprise and as an argument for social accounting and controls? What was the nature of their interactions? In the above cited letter (February 6, 1941), Clark raised his “chief concern . . . of balancing the emphasis on the negative and the positive side of the critique.” Clark contrasted the setting in which “Overhead Costs” was written to the setting of the 1940s:

[my early work was in a] setting characterized by detail attempts to correct particular defects in the system of private enterprise, involving no serious threat to the evolutionary continuance of the “institution” itself . . . the present setting is different, in that breakdown and radical transformation, which are not intended by the majority of the population and for which we are not prepared, are really threatened.

Clark warned Kapp of the danger of systemic breakdown, reminding him to be aware of his responsibility in writing his book on the social costs of private enterprise:

therefore it seems to me particularly necessary at present to do justice to the elements of positive value in the institution [private enterprise]—in short to give a balanced presentation. . . [Your] study seems to judge the system by ideal standards. And the use of ideal standards seems to me justifiable, if one keeps in mind the fact that they are unattainable, and that any actual alternative scheme would have its own imperfections to balance against the ones the existing system reveals. . . . If one of the alternatives is a thoroughgoing transformation to a collectivist system, its imperfections are necessarily conjectural, but might be quite serious; and they need to be recognized.

Additionally, Clark raised serious doubts whether a collectivist system would be inclined to institutionalize a “system of social accountancy,” fearing that the imperfections would simply be shifted from the “machinery of the markets” to the “political machinery.” This



criticism is also the core of the last documented intellectual interaction between Clark and Kapp, via Clark's book review of "Social Costs of Private Enterprise" in the Yale Review entitled "The New Economic Community." In it Clark praised the systematic elaboration of the idea that an " 'enterprise' should reckon with all the costs it occasions, including those the business unit can shift to other members of society." And with regard to neoclassical economics: "if one man's gnat is another man's camel . . . Kapp presents theorists with evidence of the size of the camels they have been swallowing . . ." However, Clark also raised questions: "has [Kapp] at certain points, charged as costs of private enterprise things that are really costs of modern methods of production under any form of organization [?] . . . is there a sound basis for presuming that a socialist government would treat these matters more justly than they are treated by a state which combines 'private enterprise' with many sided welfare policies? Is a municipality more likely to abolish the smoke nuisance from its own plant than to order a private plant to do the like?" Clark concluded that while questions remained, Kapp's book was important because it brought together ample empirical evidence for the existence of social costs, suggesting the scope and magnitude of the problem (Clark 1950: 173–174).

Both documents show not only that Kapp's critique of private enterprise was too unbalanced for Clark's taste, but also that Clark's own views on the role of private enterprise had changed since the 1920s. Since the draft of the manuscript reviewed by Clark is not available, we do not know in how far Kapp modified his critique. In this context it is of interest that Kapp's letter to Clark on December 12, 1945 referred to a working title that differs from the later book publication: "I am very grateful to you for having read parts of my manuscript on Social Costs and Returns which I submitted to you." We do not know whether Clark's influence was decisive on Kapp's decision not to publish roughly half of his original book manuscript, which contained a discussion of planning for social returns of "utilities which diffuse themselves among all members of society, . . . that are to a large extent inappropriable by individual producers and cannot always be appraised in monetary terms"<sup>7</sup> (Kapp, unpublished ms. III). Kapp had originally developed the interconnected themes of

social costs and returns in his dissertation (Kapp 1936). In the unpublished manuscript, Kapp discussed social returns

derived from the gratification of collective needs; from international economic policies designed to achieve a balanced economy . . . and from the improvement of transportation facilities . . . scientific research, multiple purpose projects (such as TVA), and the maintenance of a social minimum with respect to essential foodstuffs, medical care, housing, and education. (Kapp, unpublished ms. III)

While the issues of social costs and planning for social returns are intimately related, the “returns” portion was not published and remains in the Kapp Archives. Clark’s warnings may have caused Kapp to improve and balance his argument on social returns, an improvement evident in his later work. For example, he published the article “Social Costs and Social Benefits—A Contribution to Normative Economics” (1963) in the same year as “Social Costs of Business Enterprise.” This article, as well as various others from the late 1950s and early 1960s, resulted from research on the social costs and social benefits in development projects in India and the Philippines, and addressed the social costs and lack of planning for social returns by ineffective public administrations (Kapp 1959a, 1959b, 1960, 1961). These articles display Kapp’s openness to balancing his argument, criticizing social costs regardless of whether they were created by private or public entities. Yet, Kapp also maintained that planning for social returns and the minimization of social costs were important goals of economic development policy and that important improvements were achieved. Starting from the interconnected problems of social costs and social returns, Kapp developed a full-fledged theoretical framework of democratic controls of science and technology, socioecological indicators, and social minima (see below for more details; for a full elaboration, see Kapp 2011).

The second half of Clark’s letter (February 6, 1941) asked Kapp to consider the question of freedom. Clark saw “value in the device of imagining the setting up of a new community, with our present knowledge.” But he asked Kapp to consider

what sphere would be left to the market process, and what imperfections in that sphere would be tolerated in the interest of minimising central

regimentation and preserving the prerequisites of liberty, both of thought and expression as well as of consumption and production?

It seems that Clark perceived Kapp's critique not only as too unbalanced, but also with too little focus on the questions of the shortcomings of alternative modes of organization, such as socialism, and the prerequisites of "liberty." Curiously, this criticism is similar to the one levied against Kapp in a book review by the Chicago liberal economist Frank Knight, who had institutional leanings (Knight 1951; Berger 2012; Rutherford 2010: 30–32; Emmett 2010: 282). As an exile from Nazi Germany, an affiliate of the Frankfurt School, and a student of the poet and teacher Ernst Wiechert, Kapp took the issue of integrating freedom with the alleviation of human suffering very seriously. Perhaps due to Clark's criticisms, Kapp published "Economic Planning and Freedom" (1950) the same year as his "Social Costs of Private Enterprise," in which he argued for a substantive understanding of freedom that included planning for social returns. Clark's letter finished on a friendly note: "needless to say, I shall be interested to see how your study develops."

Four years later, on December 4, 1945, Clark wrote down his detailed comments regarding the overall scope of Kapp's draft, as well as its specific arguments. His letter consists of four densely typewritten pages, showing Clark's efforts to further influence and aid in the development of Kapp's institutional theory of social costs. As in the previous reply, the draft upon which the comments were based is not available, so that the basis for interpretation is missing. Yet the letter provides Clark's more general comments as well:

It is interesting that you are reviving the discussion of extra-market values and costs and putting content into it, with some approach to measurement.

Importantly, Clark addressed the semantic differences of Kapp's concept of "social costs":

[your definition of] "social" values and costs differs from mine in applying to non-market quantities only, where mine [Clark's] included also the quantities the market "measures".

This shows that Clark defined social costs as nonmarket plus market costs in the neoclassical tradition of Arthur C. Pigou (1929). This may

reflect Clark's attempt to improve neoclassical theory rather than repudiate it (Lee 2009: 33), which had led him to dedicate his theory of overhead costs as "a very small contribution toward realizing his [that is, his father's neoclassical] conception of a dynamic economics" (Clark in Gruchy 1967: 357). Throughout his work Kapp roundly rejected neoclassical economics and its conceptual framework in its entirety, criticizing its ineffective and overly conservative reform proposals. Kapp noted in "Social Costs of Business Enterprise" (1963) that Pigou had radicalized his political-economic conclusions by the late 1940s when Pigou (1947) had argued that the social inefficiencies had reached a level that justifies the socialization of the means of production. Yet Kapp maintained that Pigou's neoclassical concept of external costs was imbued with the limitations of the neoclassical theories of price and value, as well as its closed system and equilibrium preconceptions that preclude an adequate understanding of the circular cumulative causation underlying the problem of social costs and its complex value dimensions, as well as its open system character (Kapp 1963, 1976; Berger 2009).

Instead, Kapp distinguished private costs from social costs (social losses, damages, inefficiencies) to emphasize that businesses privatize profits and socialize as many costs as they can. Kapp defined social costs as that part of the costs of production that businesses shift to society to increase their profits, thus avoiding responsibility. According to Kapp, adding social to private costs results in total costs. In the literature, this important difference between Kapp's and Clark's definition of the concept of social costs has been obscured. This may be due to the fact that both agreed on the notion of cost shifting but disagreed on what to call the shifted costs (see Prasch 2005). Thus, it is Kapp's contribution to have elevated the concept of social costs to a stylized fact for a critique of capitalism, the system of business or private enterprise, and formal rationality, further mending and bringing into the open ideas of Marx, Veblen, and Weber.<sup>8</sup> In "The Social Costs of Private Enterprise" (1950) Kapp provides a chapter on the conceptual history of social costs, showing his commitment to engage and acknowledge the large variety of previous contributions and arguments on social costs and returns. It is also Kapp's contribution to have clearly articulated how the institutional theory of social costs

differs from neoclassical (see above) and neoliberal approaches (see below).

The significance of Clark's comments is acknowledged by Kapp in his subsequent letter (December 12, 1945):

Dear Professor Clark: I am very grateful to you for having read parts of my manuscript on Social Costs and Social Returns which I submitted to you. . . . I have studied your comments very carefully and I found them most pertinent . . . I feel that you have called my attention to serious weaknesses in the formulation of my ideas, and in most instances I have found it possible to reformulate my conclusions in a more careful and more satisfactory manner.

However, Kapp's handwritten remarks on the margins of Clark's letter indicate that he did not agree with all of his comments, leading him to reply to Clark:

The following is a brief reformulation of my ideas—a reformulation which I owe to your challenge and which I shall incorporate in the introductory chapter. . . . The thesis of this book is briefly that the orthodox appraisal and interpretation of the economic process in the unplanned market economy is invalidated by various obstacles to rational conduct and the phenomenon of social costs and social returns.

Clark's remark that the problem of social costs had already been successfully addressed by Oskar Lange and Abba Lerner and that Kapp was "beating a straw-man" challenged Kapp to clarify his aims with regard to developments in economics:

The presuppositions of classical and neoclassical equilibrium economics continue to determine both the methods and the scope of modern value theory as can be easily ascertained . . . [by] the more recent system of economics which is based upon Keynes' General Theory . . . modern textbooks . . . the works of such intransigent economic liberals as Professor F.A. Hayek, L. Mises, and L. Robbins . . . [even] some socialists of the 20<sup>th</sup> century have so accustomed themselves to the methods of thinking of neoclassical equilibrium analysis that they answer Mises' challenge of socialist planning by proclaiming that the socialist economy would solve the problem of allocating scarce resources among competing ends with the aid of the price mechanism and the competitive calculus. There is no hint that in order to solve the economic problem a planned economy is likely to base its economic decisions upon a social evaluation of total outlays and total benefits which . . . will have to take into account social costs and social returns. In other words, I am not aware of the fact that O. Lange and

Professor Lerner have any fundamental quarrel with traditional equilibrium theory, and I have the impression that there is no room in the conceptual system of these writers for the phenomena of social cost and social returns. . . . I am also aware that value theory continues to be confined to the search for levels of equilibrium “of the exchange value sort,” and not in terms of social value despite the fact that . . . economic decisions of the greatest importance are based on social choices and preferences.

This shows that Kapp aimed at a critique of all economic theories—even the progressive ones by Lange and Lerner—insofar as they adopted core elements of neoclassical economics and ignore the question of social valuation:

When I said that the search for levels of equilibrium ought to be abandoned, I meant actually that the exclusive preoccupation . . . with problems of exchange value requires supplementation by a study of social value. . . . I like to hope that in the light of this letter there is perhaps a greater area of agreement between your “Preface to Social Economics” and my “Social Costs and Social Returns” than it appeared to you after reading the manuscript. With renewed thanks for your kindness of reading the manuscript, I am Very Sincerely Yours K. William Kapp

Kapp clearly tried to convince Clark that their works were in agreement concerning the importance of social valuation in economic decision making. In the same vein Kapp explains in the unpublished draft versions of the introduction to “The Social Costs of Private Enterprise” that he aimed at a critique of social costs under capitalism, and of neoclassical and neoliberalism theories that do not capture these realities:

As an analysis of the social inefficiency of the unplanned market economy the study was bound to assume the character of a critique not only of capitalism but also of traditional equilibrium economics. (Kapp, unpublished manuscript I)

the re-orientation of economics; . . . [exploration of] the possibilities for the setting up of valid criteria for economic planning and the formulation for economic policy, and perhaps to prepare the way for the elaboration of a positive theory of social value are the chief ultimate purposes of this inquiry. (Kapp, unpublished manuscript II)

The final words of Kapp’s letter and the unpublished versions confirm that Kapp identified with Clark’s project of “Preface to Social Economics” (1936), for which he saw the argument on social costs to

be only a preliminary step. Kapp actively pursued this social economics or institutional “foundations project” for the rest of his life (Berger and Steppacher 2011).

### **Institutionalism vs. Neoliberalism: The Discourse on Social Costs**

The above letter to Clark also shows that Kapp was among the economists in the institutional movement who directed his work against the “intransigent” liberalism of Friedrich A. Hayek. Moreover, the unpublished draft version of the preface to “Social Costs of Private Enterprise” (1950) states that the core thesis of the book is directed against a revival of liberalism reflected by the success of Hayek’s and Mises’s works (for details, see Berger 2012). Unlike Clark’s contribution on overhead cost, Kapp’s social costs argument emerged less as a critique of neoclassical economics than as a late reply to von Mises’s argument in the European socialist accounting debate of the 1920s. Kapp’s dissertation “The Planned Economy and International Trade” (1936) developed the social costs argument as a socialist “countervailing impossibility thesis” against Mises’s famous neoliberal impossibility thesis. That is, according to Kapp, an accounting system based on market values cannot account for the social value of damages because the latter cannot find “value expression” in exchanges between isolated individuals (Kapp 1936; Berger 2012). Therefore, Kapp concluded, allocation in a pure market economy cannot be rational. Thus, Kapp’s theory on social costs was originally motivated by the emerging Austrian neoliberalism in Geneva (Plehwe 2009). At this time, Kapp was also closely affiliated with and influenced by the Frankfurt School, exiled—like Kapp—in Geneva, so that the initial development of his argument on social costs can be seen also as a contribution to the Frankfurt School’s post-Weberian project, which Foucault identified as trying to show the “irrational rationality of capitalism” (Foucault 1979: 106).

In this context it is of interest that Clark’s book title “Alternative to Serfdom” (ATS) (1948) is a clear reference to Hayek’s “Road to Serfdom” (RTS) (1944), and that Kapp’s copy of ATS shows intense underlining and three handwritten pages of notes, indicating his agreement with Clark’s arguments, in particular the beneficial role of

unions and the need to focus economic inquiry on human needs. Kapp's copy of Hayek's RTS likewise shows 10 marks in the margins, including pages 37–39 on social costs and social returns, and contains six newspaper clippings from the debate stirred by Hayek's RTS and Mises's "Bureaucracy" (1944). Hayek's views on social costs evolved after RTS, and his mature point of view on social costs was diametrically opposed to Kapp's. This became especially evident in Hayek's justification of the social costs of Pinochet's dictatorship, which Hayek considered "a necessary evil" in implementing the (neo-)liberal agenda (see Farrant, McPhail, and Berger 2012: 530). Like Hayek, Kapp also contributed to a newspaper debate following the installment of Pinochet's dictatorship. In his article, which the editor of the Swiss newspaper "National-Zeitung" had solicited, Kapp warned of a new "right-wing extremism that puts on the costume of liberalism" (Kapp 1974: 6). Yet Kapp mentioned no names in this article, nor did he direct his final manuscript of "Social Costs of Private Enterprise" or any of his articles against Hayek or Mises. The most probable explanation is that Kapp hoped for a genuine dialogue on the substance of the issue by avoiding an unbalanced ad hominem attack.<sup>9</sup> Kapp's intellectual engagement with neoliberal economics is also evidenced by a book review that critically assessed Eucken's posthumous work on economic policy (Kapp 1953). Kapp noticed the distinct constructivist element in Eucken's work, which, according to Mirowski (Mirowski 2009), is the hallmark of neoliberalism and distinguishes it from laissez-faire neoclassical economics. Kapp's main criticism was that this approach excluded evidence that is contrary to its preconceptions, that is, that Eucken considered social costs as minor exceptions rather than systemic problems that require more substantive controls. Kapp also noted that Eucken's "idealtyp" of the exchange economy is too abstract, with no allowance for "less harmonious" facts of economic life, such as systemic social costs.

It is important to note that Kapp's social minima proposal for minimizing social costs (Kapp 2011) is a substantivist reply to minima proposals developed by (neo-)liberal economists, that is, the minima proposal of Walter Eucken (Foucault 1979: 141, 204–206) and Hayek's "non-discretionary rules" argument (for a discussion of Hayek's



argument, see Burczak 2011). The difference lies in the extent to which Kapp wanted social minima to control the economic process. That is, he proposed a full-fledged democratic governance of science and technology decisions, including socioecological indicators, to guarantee the maintenance of social minima (Kapp 2011). Contrary to neoliberalism, Kapp's approach endorses a social and democratic dynamic centered on universal and scientifically objectifiable human needs, and the absolute value of human life in the Kantian tradition. The neoliberal approach that turns human life and needs into a means to an end is rejected by Kapp, so that social costs cannot be justified as a "necessary evil" to achieve economic growth, profitable exchanges, or some neoliberal notion of purely formal economic freedom. Kapp dubbed his approach "new rational humanism" (Kapp 1985) based on a theory of integrated social knowledge centered on and derived from a scientific biocultural concept of the human being. In this, Kapp pulled together research on human needs from various humanist scientists and psychologists, for example, Abraham Maslow and Erich Fromm. Kapp placed this approach in the tradition of European substantivist arguments made by Carl Menger and Karl Polanyi (Berger 2008) but also American biocultural approaches of Thorstein Veblen and John Dewey (Kapp 1961; Gerber and Steppacher 2011; Kapp 2011).<sup>10</sup> In sum, Kapp's institutional theory of social costs was part of his larger intellectual project of a new rational humanism and an attempt to counter neoliberal arguments.

The success of Kapp's institutional theory of social costs during the 1950s led various key figures of the "neoliberal thought-collective" to respond or comment directly, for example, Frank Knight (1951), Guido Calabresi (1961), James Buchanan (1962), and Wilfred Beckerman (1972) (for details, see Berger 2012). Post-WWII developments in economics need to be seen as a reaction to institutional economics, with the Chicago School sharply at ideological odds with institutionalism (Rutherford 2011: 351; Mirowski and Plehwe 2009; Van Horn et al. 2011). As Rutherford has pointed out, Chicago economists often modified or reworked existing institutional economics' ideas (Rutherford 2010: 36). In the discourse on social costs, this is best demonstrated by how Coase (1960) and Stigler (1966) contributed to the discourse on social costs. Both remained conspicuously silent on

previous institutional arguments and celebrated their argument on the institution of property rights as a “scientific discovery.” Stigler’s “Coase Theorem” shifted the discourse from the problem of “social costs” to a problem of “transaction costs,” corresponding with his lack of interest in actual social damages (see Medema 2011). Instead of seeking ways to prevent social costs *ex ante*, which was the primary concern of Kapp’s theory of social costs, Stigler focused on constructing *ex post* market-based solutions by minimizing transaction costs and assigning property rights. Stigler did not engage previous institutional arguments concerning the predatory and subreptitious aspects involved in assigning property rights and the impossibility of adequately reflecting social and ecological values in individual market exchanges.

It seems likely that Stigler’s contribution to the discourse on social costs was part of his many “demolition derbies” against institutional economics, which he hated: “Institutional economics is dying out at a fantastic rate—though still not fast enough to suit me” (Stigler, in Rutherford 2011: 328).<sup>11</sup> Due to his overt dislike for institutional economics, it seems reasonable to presume that his silence on Clark’s and Kapp’s well-known arguments on social costs was not an innocent oversight. Clark’s work was so prominent that he had received the Francis A. Walker medal by the American Economic Association in 1952, “given to that living American economist who . . . has made over the course of his life the most distinguished contribution to economics” (Shute 1997). Instead of seeking a discourse with institutional economists, Stigler promoted Knight’s “Some Fallacies in the Interpretation of Social Costs” (1924) in his publications on price theory (Stigler and Boulding 1952) and in his “Coase Theorem” (1966). Additionally, Stigler was among the “commentators” who encouraged Coase to write “The Problem of Social Costs” (Coase 1960, fn 1; see the “Eureka” event in Medema 2011). Coase refers to Stigler’s argument that the problem of social costs should be conceived of as purely “reciprocal nature” (Coase 1960: 2), rather than social or systemic. Much like Stigler, Coase adopted a very disparaging attitude towards institutional economics, describing it as “a mass of descriptive material waiting for a theory, or a fire” (Coase in Rutherford 2010: 25), and also remaining silent on Clark’s and Kapp’s arguments on social costs.

### Conclusion

This article demonstrates that the dominant narrative about the discourse on social costs is incomplete. The findings show that the discourse includes Clark's and Kapp's institutional theory of cost shifting and social costs. The latter reflects a distinct and clearly distinguishable institutional argument on social costs, which further develops earlier ideas by Veblen and Marx. Thus, the institutional theory of social costs is a clearly distinguishable alternative to neo-classical and neoliberal arguments. The Kapp-Clark correspondence shows that Clark was influential in the development of Kapp's institutional theory of social costs and social returns. Throughout their works, both economists harnessed the enormous power of their argument on cost shifting as a rationale for increasing social controls of the economy and the development of a genuine social economics. Yet the archival materials also illustrate that both economists differed on the definition of social costs, and that Clark encouraged Kapp to balance his critique and to consider improving certain weaknesses of his argument. Their correspondence provides further important documentation that Kapp developed the institutional theory on social costs to counter "intransigent [neo-]liberalism," and that leading neoliberal economists sought strategies to undermine and eclipse the institutional argument. Thus, the discourse on social costs cannot be fully understood without appreciating the role of the institutional argument on social costs. This account differs markedly from other recent accounts, ending the hermeneutic "stop play" strategy that fails to acknowledge institutional theories. Thereby, this article contributes to the important advancement of understanding social costs via the "ethics of play" (Vilhauer 2010; Samuels 1990; Arrington 1990).

### Notes

1. For an elaboration of Kapp's institutional argument against the return of liberalism and the reaction of leading neoliberal economists, refer to Berger (2012).

2. It is noteworthy that the financial support for institutional economists waned since the 1950s, with the Ford Foundation being the last to quit funding institutional research by the early 1960s (Rutherford 2011). Myrdal's and Kapp's project to start an international association of institutional

economists was denied funding by the Swedish Research Council in 1968 (for details concerning Kapp's intellectual project, see Berger and Steppacher 2011). This may be seen as a consequence of changes in the way economic science was funded with several foundations increasingly supporting neoliberal ideas, for example, the Volcker Fund and the Walgreen Foundation (Mirowski and Plehwe 2009; Nik-Khah 2011).

3. See also Swaney and Evers (1989), who have located this important concept at the core of the institutional theory of social costs.

4. Clark's "Accelerator Principle" is based on the idea of self-reinforcing causation (vicious circle) or circular and cumulative causation, which is one of the key concepts of nonequilibrium economics (Berger 2009).

5. This issue was at the heart of the European socialist accounting debate in the 1920s (Kapp 1936).

6. The Kapp-Clark correspondence—retrieved from the Kapp Archive—contains five letters. Two letters deal with Kapp's article on consumer theory, "Rational Human Conduct" (1943), and three letters concern Kapp's book manuscript "Social Costs of Private Enterprise" (1950). The present analysis only refers to the latter set of letters.

7. The section on social returns was never published. In this, Kapp provides an institutional version of Paul Samuelson's neoclassical "public goods" argument (Samuelson 1954),

8. Leading authors using the institutional argument on social costs in the tradition of Kapp work are Swaney and Evers (1989), Swaney (2006), Sherman et al. (2007), Foster (2000, 2010), and Martinez-Alier (2002).

9. For a similar thesis, see Swaney and Evers (1989) and (Franzini 2006).

10. Today Kapp's approach resembles in important ways Amartya Sen's "capabilities approach" and Max Neef's human needs matrix.

11. Recent archival research has elevated the role played by Stigler as a key protagonist of the Chicago School with a coherent agenda in the areas of law and economics, and science and technology (Nik-Khah 2011), contributing to the demise of the institutional argument on social costs.

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